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C O N F I D E N T I A L SECTION 01 OF 04 BAKU 000377

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SUBJECT: NEXT STEPS ON EURASIAN ENERGY STRATEGY

Classified By: Charge D'Affaires Donald Lu, Reasons 1.4 (b,d0

¶1. (U) Embassies Ashgabat, Ankara and Astana have provided input for this cable.

¶2. (C) SUMMARY. The USG needs to intensify its engagement on Eurasian energy issues, and do it quickly. In Azerbaijan, lack of progress on creating a "Southern Corridor" for Caspian gas, due primarily to Turkey's unwillingness to provide clear transit terms to European markets, has already stalled Azerbaijan gas development and makes it less likely that Turkmenistan will seek to send gas west. Lack of expertise and experience in creating and operating complex legal, technical and commercial structures, along with excessive rent-seeking activity, could weaken the overall commercial viability of western shipment of the massive volumes of anticipated Kazakhstani crude oil that will begin to come to market around 2013. Such an outcome increases the chance that more of these Kazakhstani volumes will go south to Iran or north to Russia. In Turkmenistan, lack of a suitable business climate for foreign direct investment by international energy companies keeps Turkmen gas production at relatively low levels, while Russian high-level political attention to Ashgabat allows Gazprom to continue its control over Turkmen gas exports.

¶3. (C) SUMMARY (CONT): For these and other reasons, Embassies Ankara, Ashgabat, Astana and Baku welcome the appointment of Ambassador Morningstar as Special Envoy for Eurasian Energy (SE), whose regular visits to regional capitals will strengthen our bilateral energy cooperation. We suggest he focus on working with the GOAJ and the GOT towards Turkey allowing commercially viable transit for Caspian gas seeking European markets while also ensuring that Turkey is able to buy additional upstream gas to meet its growing domestic energy needs. Such a solution must both allow Azerbaijan to sell its gas at commercially acceptable terms to customers it chooses, while also allowing Turkey to derive a benefit from gas pipelines crossing its territory. In this regard, we are on the verge of a potentially important breakthrough on gas transit fees for the East-West energy corridor. The Nabucco IGA slated to be initialed in Prague in early May and signed in Istanbul in June contains provisions for a transparent tariff formula that will be agreed by all Nabucco partner countries. We suggest SE work with all Nabucco partner companies with special attention to Turkey and the EU to ensure such an agreement gets done. The signing of this IGA could be a milestone in opening the East-West energy corridor and could serve as a model for other projects. We recommend SE also continue to follow developments related to other pipeline projects (to include TGI) as the USG, previously seen by many as focused exclusively on promoting Nabucco,

should not be seen as championing specific pipeline projects to the exclusion of other, equally if not more viable projects. For many reasons, Nabucco could be too ambitious a project in its slated timeframe, whereas less complicated projects like TGI could be more commercially viable at present or could be seen as a first step in a larger East-West energy corridor. Additionally, we suggest SE Morningstar work with the International Energy Companies (IOCs) in Kazakhstan's Kashagan and Tengiz consortia, to ensure that their views are sufficiently reflected in the Trans-Caspian Project (TCP) for shipping Kazakhstani oil through Azerbaijan. In Turkmenistan, we suggest he focus on encouraging the GOTX to facilitate foreign direct investment in the hydrocarbon infrastructure so as to facilitate optimal production, while also working to facilitate IOC participation in the development both of the GOTX offshore and onshore gas sector. END SUMMARY.

¶4. (C) OVERVIEW: Europe now consumes almost 600 bcm/a annually, about 50 percent of total gas consumption is produced in Europe and 50 percent is imported. Russian gas accounts for about 33 percent of Europe's total gas consumption or about 66% of its imported volumes. By 2030, this is expected to grow to 700-730 BCM, given expected economic growth and Germany's closing down its nuclear plants. But with the continued exhaustion of North Sea and Dutch gas reserves, an even larger percentage of that future supply, about 70 percent will come from imports, and a large portion of that increase will come from Russia absent alternatives.

¶5. (C) OVERVIEW (CONT): The largest East-West corridor plan, Nabucco, aims to import at least 30 billion cubic meters annually (BCM/a) to Turkey and Europe to be commercially and strategically viable. While that will not dramatically reduce Russia's monopolistic position, every alternative source contributes to loosening the European gas market and alleviating in particular the political leverage of Russia's position. The problem is that the primary source for near-term gas for Nabucco, Azerbaijan's Shah Deniz II, can provide only 12-14 BCM at the Turkish border. Depending upon Turkey's "takes", of between 4-8 BCM/a, there may not be enough 'starter' gas to Europe (8-10 BCM/a) to get the project up and running. Longer term, to be viable additional gas for Nabucco would have to come from non-Azerbaijani sources, possibly Turkmenistan, Iraq, or, if politically feasible, Iran.

¶6. (C) An optimal USG Eurasian Energy policy should flow from and be integrated into the overall USG approach to the Caucasus, Central Asia, Russia, Turkey and Iraq, as well as European Union members to the West. Such a policy should seek to ensure the long-term independence and stability of those Caspian region countries of strategic interest to the United States, such as Azerbaijan, Kazakhstan, and Turkmenistan, while acknowledging Russia's enormous production and exports, Europe's rising demand, and Iran potential as a supplier should its geopolitical status change. The Caspian countries have substantial hydrocarbon resources and face a great risk as a resurgent Russia seeks to monopolize their oil and gas reserves, Iran makes plans to develop its huge reserves, and Turkey remains uncooperative on gas transit.

¶7. (C) The long term independence and stability of Azerbaijan, Kazakhstan, and Turkmenistan can best be ensured by swiftly and efficiently developing their hydrocarbon base, resulting in needed national income and economic growth, and strategic links with Europe and the West. This hydrocarbon development requires cooperation among IOCs and the respective governments and national oil companies, a process which is already underway. These countries must also have hydrocarbon export options, so they are not dependent on any one customer or transit country for their income. Finally,

these and other Eurasian countries must expand and strengthen their economic inter-relations that can, inter alia, make the "Caspian Region" as much an economic reality as a geographical one.

¶8. (C) Given large gas reserves in Iraq and Turkey's willingness to build a pipeline to connect with these resources with the East-West energy corridor, we should encourage the government of Iraq to export gas to Europe. We understand the political situation in Iraq is complex and the legal and regulatory framework for gas export is not yet in place. W also acknowledge Iraq's own growing need for gas. However, we continue to hear about plans for Ira to export gas to Syria and perhaps south to Egypt. To the extent gas is available for export, the U.S. should encourage Iraq to use gas exports to forma strategeic relationship with Europe which would give Europe an important stake in Iraq's future.

¶9. (C) Implementing such an energy strategy would take the following form in the following countries:

AZERBAIJAN: Azerbaijan is important both as a producing and transit country. Its approximately one million barrels of oil per day that started flowing from its ACG field in 2006 makes it one of the most significant sources of additional non-OPEC oil to recently come on-line. As importantly, it can serve as a transit country for the rapidly increasing volumes of Kazakhstani oil seeking ways to market that are not dependent on Russian or Iranian routes. Although Azerbaijan is a mature oil producer, its natural gas production is set to increase significantly, allowing it to become an important gas supplier to European and other markets. Azerbaijan is keen to be a transit country for both Kazakhstani oil and Turkmen gas flowing westwards, offering both these countries a viable option for moving their hydrocarbons to Western markets via non-Russian, non-Iranian routes.

USG and Azerbaijan have cooperated closely on energy issues and share the same strategic vision. Azerbaijan's goal

remains to deliver gas to Europe through Turkey, thereby bolstering its strategic ties to Europe. However, for over a year it has unsuccessfully sought to persuade Turkey to pay a commercially viable price for the Azerbaijani gas it is already receiving from the Shah Deniz field, and to allow transit of future Azerbaijani gas to European markets under internationally accepted, commercially viable transit conditions. In the wake of recent tensions with Turkey over rapprochement with Armenia and given the failure to agree on transit terms, the GOAJ has recently began to signal that if transit terms cannot be agreed with Turkey, it may seek new relationships with Russia to allow Azerbaijani gas to either be delivered to Europe through Russia, or sold directly to Russia. In addition, what the GOAJ perceives as USG reluctance to address more actively and constructively other, non-energy, concerns in the bilateral relationship could adversely impact the energy agenda. To achieve our energy, security and democracy objectives here, we need to elevate and intensify our overall strategic relationship with Azerbaijan, and to continue working closely with Azerbaijan in its efforts to work with Kazakhstan and Turkmenistan in jointly developing and transporting oil and gas.

TURKEY: Commercially viable westward transit of Caspian oil and gas to Europe via non-Russian routes requires Turkish participation. For the last 18 months, however, efforts to conclude a transit agreement for Caspian gas through Turkey to European markets, in volumes sufficient to sanction at least one gas pipeline project (Nabucco, TGI or TAP) have failed, and relations between Azerbaijan and Turkey, for this and other reasons, are becoming strained. For months, the GOT has maintained it cannot grant transit rights to Caspian gas without some assurance that Turkey will have the right to buy some of the gas to meet its own growing gas needs. The

U.S. has encouraged Turkey to strike a bilateral gas sales and purchase agreement with Azerbaijan to meet its domestic demand. For its part, the EU has proposed the concept of a Caspian Development Corporation (CDC) which would aggregate EU demand in hopes of attracting Turkmen gas to Turkey and Europe. While there are concerns in Washington concerning competition, CDC is the best example yet of the EU pulling together on the southern corridor and it will is an important component of our strategy to move Turkey to yes on transit issues.

The GOT said it will be ready to sign the Nabucco IGA in June. If the GOT indeed follows through, it might help break the impasse on transit terms. According to representatives from RWE and OMV, an annex to the IGA includes a transparent tariff formula that is agreed by all Nabucco partner companies that would be used to calculate the cost of transporting gas from point A to point B. The IGA will also include provisions for taxation which is how the national governments will make money on Nabucco. Turkey will not be able to impose any additional provisions on transit. It is not clear whether the tariff and tax formulas will be acceptable to Azerbaijan, which wants Turkey to grant commercially viable transit to all upstream gas, as opposed to being presented with the fait accompli of only a Nabucco option. Even if Azerbaijan finds the Nabucco IGA as a necessary but not sufficient condition, such a disagreement might move the discussion to one between Nabucco partner companies and potential gas suppliers, rather than between Turkey and Azerbaijan. The United States should encourage Turkey to support the Nabucco IGA. If the IGA is signed, we should encourage Azerbaijan, Turkey and other potential gas suppliers to view the IGA transit formula as a model for other projects. As discussion advances on other transit pipelines, the U.S. must continue to support solutions that are offered by commercial partners without whose support these projects will fail.

KAZAKHSTAN: Kazakhstan is poised to become an increasingly significant source of non-OPEC oil. Its Kashagan field alone, slated to start production in 2013, is expected to provide 1.5 million barrels/day to world markets, and production at Tengiz is expected to grow to 1.1 million barrels/day. Currently, there is not enough export capacity for these new expected volumes, and IOCs in Kazakhstan in conjunction with national oil company KazMunaiGas are looking for commercially viable export routes, to include one that flows westward through Azerbaijan to Georgia and Turkey. U.S. and other international companies continue to press

Russia and other partners for expansion of the Caspian Pipeline Consortium, which runs to the Black Sea. The USG, in promoting multiple routes to market, needs to ensure the commercial viability of westward export of Kazakhstani oil through Azerbaijan, while continuing to discourage swaps and other mechanisms to and through Iran. As such, it needs to make the commercial viability of Kazakhstani oil transit a strategic issue in Azerbaijan, to increase IOC participation in creating the necessary legal, commercial and technical infrastructures, and to minimize the current rent-seeking activities that are imperiling the projects' viability.

TURKMENISTAN: Russia's pre-eminence in European gas markets has been facilitated by its ability to purchase Turkmen gas for its own markets and Ukraine, while selling its own West Siberian gas to Europe at premium prices. Turkmen gas flowing westward) transparently, to Ukraine and beyond) via Azerbaijan could greatly increase the commercial viability of a "Southern Corridor" of Caspian gas to Europe. Russia knows this well, and places great emphasis on keeping Turkmen hydrocarbons moving northwards. Realizing that for largely political and technical reasons it is unlikely that significant amounts of Turkmen gas will be flowing westward in the short- to mid-term, any successful USG Eurasian energy policy must focus in the long-term on creating conditions

within Turkmenistan conducive to IOC investment in and development of its gas resources, especially offshore. In this regard, frequent trips by SE Morningstar to Turkmenistan to meet with President Berdimuhammedov and help "bring him along" in realizing the importance of a business environment receptive to FDI, and the importance of IOC participation in developing Turkmenistan's onshore gas reserves is essential.

China: While Russia's policies with regard to Central Asian/Caucasus resources are well studied and discussed, China's arrival on the scene is relatively new and quiet but arguably just as important. The flow of Kazakh oil eastward to China and future flow of Turkmen gas, are also "wins" for a Eurasian energy policy that focuses on diversity of export. As China becomes more willing to pay market prices for oil and gas, increasing amounts of Caspian (as well as Russian) hydrocarbons should flow eastwards. We should not regard these developments as hydrocarbons "lost" to Europe. Rather, the U.S. should begin thinking about ways to cooperate with China in Eurasian energy development.

¶10. (C) Finally, it bears noting that in conjunction with our energy policy in Azerbaijan, Kazakhstan and Turkmenistan, we must work with them to further a long-term, organic process of economic integration and political development, so as to better ensure their long-term security and stability. Part of this effort should be on increased transparency and furthering the rule of law. In Azerbaijan and Kazakhstan, the Extractive Industries Transparency Initiative is a good step along this route.
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